United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

Docket No. 74-2108

IN THE

United States Court of Appeals

For the Second Circuit

UNITED STATES OF AMERICA,

Appellee,

—*v.*—

THOMAS M. FAHEY,

Appellant.

On Appeal From the Judgment of the United States District Court for the Northern District of New York

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REPLY BRIEF FOR APPELLANT
(Thomas M. Fahey)

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REPLY BRIEF FOR APPELLANT

(Thomas M. Fahey)

OVER-ALL COMMENT ON THE GOVERNMENT BRIEF -- Made necessary by the nature of the Government response to the very precise, clear, and well-defined issues of law presented by the Appellant.

The Appellant made it very clear in his brief (p. 20) that he was not challenging any of the facts that went to the jury.

The Appellant accepted these facts, and raised very specific, well-defined, and clear points of law on appeal.

What the Government did in all of its replies to Appellant's points of law was to inject and extensively argue questions of proof as though they were at issue.

We submit that this was highly irregular and inappropriate. We also submit that the reason the Government did this was because

(1) They had nothing of substance to use in response to the points raised, and

(2) They had to create the semblance of a response, and perhaps blur the clarity of the issues.

We are pointing this out, not merely to criticize the Government, but to explain how we have organized our reply brief to retain the clarity of the appeal, instead of adding to the confusion.

We are referring specifically to Points I, II, III, and IV of the Government brief, which responds to the corresponding by numbered points of Appellant's brief.

Points I, II, and III of Appellant's brief assumed all the facts as given to the jury and raised specific points of law. Point IV deals exclusively with sufficiency of the proof with respect to (1) taxability of income, and (2) intent.

What the Government has done is to include under Points I, II, and III substantial, but irrelevant, discussions of the sufficiency of the proof. --In our reply brief, we have answered under Point IV all the Government discussions of sufficiency of proof that were incorrectly included under Points I, II, and III.

Under Points I, II, and III we reply only to whatever relevant points of law remain to be answered.

We also feel obligated to mention to this Court that we were astonished to find the Government brief replete with a combination of the following factors -- distortions and material enlargements on the testimony and exhibits, misstatements of fact (false statements), and completely misleading statements of law.

Although we cannot be side-tracked into discussing all of these in this reply brief, we will discuss those we consider are the most significant.

The Government's brief, filed November 1, 1974 (hereinafter cited as G. Br.), fails almost completely to meet the contentions in the Appellant's main brief, (cited as App. Br.). In addition, the Government's brief at a number of places misstates the record.

We shall endeavor to deal, as summarily as possible, with the basic errors contained in that brief, and thereafter with the specific matters in it which seem in most urgent need of correction.

The Government asserts (G. Br. 2, 5) that the Appellant cannot now be heard to claim plain error because of a "concession" as to taxable income and because there was no request to charge as to the pertinent law. To the contrary, the Appellant filed a detailed memorandum of law with the Court which can be considered a request to charge (R. 499, 514, 524). Moreover, the Government overlooks the fact that it had filed requests to charge concerning the defense of reliance on the advice of counsel and also on the question of taxable income (R. 1010, 1020, 1024). Significantly, the Trial Court never ruled on any of the requests to charge at any time during the trial.

In the last analysis, it is the duty of the Court to give such instructions as will adequately and fully instruct the jury on the applicable law. In a criminal case, the Court is required to instruct on all essential questions of law, whether requested or not. Morris v. U.S., 156F. 2d 525, 527. 169, A.L.R. 305 (9th Cir. 1946). Moreover, the Defendant is entitled to instructions on any defense theory for which there is a foundation in the record. Perez v. U.S., 297 Fed. 2d 12, 15, 16 (5th Cir. 1961).

The Government's raising of a new issue of law relating to guaranteed payments (G. Br. 2) only serves to underscore the claim of plain error since the Trial Court failed to make any reference to this pertinent rule of law.

As given, the charge permitted the jury to consider all increases in gross income as reportable taxable income and to, therefore, disregard the evidence that certain income (draws) was not taxable. There was a great danger,

therefore, that the jury assumed that once the Government established the figures in its tax computations, the crime of tax evasion automatically followed. In short, there exists the strong possibility that the jury inferred the willful evasion of taxes from income increases alone.

The Government asserts (G. Br. 12) that "the assistant was preparing for the trial and encountered reluctance on the part of the accountant witness, Boers, to cooperate with that preparation." No record references are cited in support of this assertion, and we think that none are available.

An equally bold assertion appears at G. Br. 13. where it is said "It is the kind of problem that defense counsel, who had full knowledge of its existence prior to trial, should have presented to the Trial Court in the first instance." Again, no record reference is cited; and again, the record (R. 5a) proves the correctness of the Appellant's statement.

Where prosecutorial misconduct occurs, it is a denial of a defendant's constitutional right to a fair trial. The conviction must be vacated and a new trial must be ordered unless the Court is able to declare that the error was harmless "beyond a reasonable doubt." Chapman v. California, 386 U. S. 18, 24 (1967).

To permit the prosecution to obtain the testimony together with books, papers, and records of witnesses through the Grand Jury when they could not be secured through the warrant procedure, would be to "watch the prosecution evade its own constitutional restrictions."

Such a decision would "encourage prosecutorial exploitation of the Grand Jury process", at the expense of personal security. United States v. Mara, 93 S. Ct. 774 (1973), Justice Marshall in dissent at 789.

This concept of eliminating the possibility of prosecutorial abuse is central to Justice Douglas' opinion [Id. at 779 (Douglas, J. dissenting)] as well as the Court of Appeals' decision.

It accords with fundamental principles of responsible government to require the prosecutor to determine that the Grand Jury inquiry is being launched for the only kind of objective with which it may proceed. It strays dangerously from those principles to allow the blurring of purposes and limits proposed here. If the prosecutors are held--and hold themselves--within proper bounds from the outset, there is in that restraint at least a degree of protection for the people. But the citizen ought not to be remitted to reliance upon official benevolence as his protection against slippery ambiguities. Whenever it is possible, as it is here, the lines should be clear.

Nothing said herein is meant to overlook the Supreme Court's realistic observation that evidence acquired in a legitimate Grand Jury inquiry may later be usable even though it has been concluded that no indictment should issue. See United States v. Procter & Gamble, 356 U. S. 677 (1958). That is wholly different from the proposition that the inquiry may start out or continue with the explicit purpose of discovering evidence. A cynic might question, of course, whether a distinction of this sort is realistic. Could not the prosecutor profess the licit purpose while intending otherwise all along? But that sort of question springs from premises which, if they were or become correct, would mark the end of honest and responsible government. Such premises are, moreover, belied by the very nature of the problem before us: the Government's attorney has admitted its purpose. It is assumed that the representatives of the Department of Justice will not question but will affirm in action, that the obligation of citizens to "turn square corners when they deal with the Government," Rock Island, Ark. & La. R. R. v. United States, 254 U. S. 141, 143 (1920) (Holmes, J.), is a reciprocal one.

I

REPLIES TO GOVERNMENT RESPONSES TO ARGUMENT I

(The trial court erred in not granting a judgment of acquittal as a matter of law on the ground that payments to partners -- made pursuant to an agreement between partners that such payments are draws -- are not taxable income.)

A. Guaranteed Payments

The Government contends that the payments received by the Appellant from the Castle Rest Nursing Home in 1966 and 1967 were "guaranteed payments" within the meaning of Section 707 (c) of the IRS Code (26 U. S. C. Sec. 707 (c), and were therefore taxable income.

Our reply is that the payments received by the Appellant clearly did not fall within the meaning of "guaranteed payments" because they do not meet the requirements established for such payments.

The requirements are clearly spelled out in the IRS Regulations (Section 1.707-1(c)) -- and also in the cases cited by the Government, Falconer v. Commissioner, 40 T. C. 1011 (1963), and Miller v. Commissioner, 52 T. C. 752 (1969), which we submit support the Appellant, and not the Government.

The most obvious test of a "guaranteed payment", that appears in both the IRS Regulations and in the cases cited, is that it has to be paid, or credited to him in some form.

This satisfies the requirement that the agreed upon payments are made "without regard to the income of the partnership." In both of the cases cited, the intended recipients actually received the "guaranteed" amounts. The recipient ". . . acquired a right to such payments which were not subject to the fortunes of the partnership . . . ", Miller v. Commissioner, supra, 759, 760.

By no stretch of the imagination can this be said to have happened in this case.

Even though the Appellant had signed two Partnership Agreements in 1965, one in January, and one in November, calling for a "salary" of $20,000 under "Article 7. Profits and Losses" (Exhibits 3 and 19), the partnership was able to pay him nothing during all of 1965, and then only $14,999 in 1966, and $11,667 in 1967.

Thus, the purported guarantee was never given effect, and whatever the Appellant did receive was directly related "to the fortunes of the partnership" and was certainly not paid "without regard to partnership income".

If the "guaranteed payment" had been given effect, the $20,000 called for in the Partnership Agreement would have been treated as an accrued item of partnership expense. Then, even if the partnership could not afford to pay the full amount, this would have created a balance due (the difference between the $20,000 and what was actually paid) which would be an obligation owing to the Appellant from the partnership that would have to appear on the books of the partnership.

However, since the "salary" agreement was never given effect, the "salary" numbers were never used, and only the "draw" numbers were always used on the books and on the U. S. Partnership Returns, for all partners.

This practice was continued after September, 1967, when all three partners began to receive agreed-upon payments for services rendered, apart from the distribution of profits, under the agreement that the payments were "draws" and not "salaries" within the meaning of "guaranteed payments".

Thus, all the payments received from the partnership by the Appellant fail completely to meet the requirements specified in the IRS Regulations and in the cases cited, and were never "guaranteed payments" within the meaning of 26 U. S. C. Sec. 707 (c).

B. Combined Salary Theory

We have two short replies to the "combined salary" theory put forth by the Government that the $20,000 was to be paid by combining amounts received from (1) the partnership, and (2) Culotti Construction.

There is no basis in law for this theory because it is not part of the Partnership Agreement that any money was to be received from a third party. There is also no basis in fact for such a theory, as we have already pointed out in the Statement of Facts of our main brief.

It is only what was received from the partnership that is relevant in this case.

C. Agreements By Partners Regarding Draws

The Government contends that there is no basis for the contention that, if the partners agree these payments are draws, then they are not taxable.

The burden here is not on the Appellant, but on the Government if they seek to show that partners are denied the power or the right to consider payments to themselves as draws.

It is fundamental partnership and accounting law that partners can determine whether payments to themselves will be "draws" or "salaries".

The recognition of this power is implicit and inherent in the very regulations governing "guaranteed payments". The partners can decide whether payments to themselves are or are not to be treated as "guaranteed payments".

If they are, then the payments will be expensed to the partnership and will be taxable income to the partners.

If they are not, then the payments will not be expensed to the partnership, and will not be taxable income to the partners.

We suspect the Government may be under the misapprehension that a partnership choice between taxable "salaries" and non-taxable "draws" will result in a tax loss to the Government.

This is, of course, not true. Selecting "draws" or "salaries" merely changes the direction in which the taxable income flows.

If "salaries" are selected, part of the taxable income flows directly to each partner, and part flows through the distributive share of net income. -- If "draws" are selected, all the taxable income flows through the distributive share of net income.

Thus, in the case of the Appellant, if the payments he received are correctly considered "draws", the Government would not lose any taxable income. It would simply increase the taxable income (or decrease the losses) of the other two partners.

We submit to this Court, as Appellant's expert CPA, Mr. Gravante, testified, that given the agreement of September, 1967, regarding "draws", the accounting firm should not have charged the draws received by Appellant as an expense to the partnership, as they did not charge the draws of the other two partners.

There was nothing to prevent the setting up of these draws by Appellant as an indebtedness or obligation to the partnership, a condition which is anticipated and provided for in the Partnership Agreement itself (Exhibit 19; Article 12. Purchase of Interest of Junior Partners).

This would not be "new income" to the Appellant, which the Government suggests, without reference to anything in the record, or to any authority except their own version of "common sense".

We respectfully submit to this Court that in the absence of any point of law submitted by the Government to bar the operation of the September, 1967, agreement of the partners regarding "draws", the payments received by Appellant must be considered non-taxable by virtue of that agreement, and the judgment for acquittal should have been granted.

II

REPLIES TO GOVERNMENT RESPONSES TO ARGUMENT II

(The Trial Court committed plain error by failing to include in the charge any mention of the applicable law of taxable income in a partnership.)

A. Level of Complexity

The Government has not been directly responsive to Appellant's argument. They put forth the proposition that the charge should reflect the level of complexity of the facts of the case.

We have no particular quarrel with that principle. It is simply not the point that was raised by the Appellant.

B. Ignorance of the Law

The objection raised by the Appellant is that the jury had no instructions whatsoever on the applicable rules of partnership law. This is a matter of ignorance rather than complexity.

Partnership tax law itself is complex. Few professionals, and very few laymen, are aware of even the most rudimentary principles of partnership tax law.

No one can expect any jury to be aware of the distinction between, and the taxable significance of, "draws" and "salaries", partnership "agreements", what "taxable income" is in a partnership, to say nothing about "guaranteed payments".

To any ordinary juror, the idea of receiving a "large" sum of money withour "reporting" it is immediately highly suspect.

We submit that, in this case, the jury needed appropriate taxable income instructions to decide both basic questions of the case -- taxability and intent.

With respect to taxability, they needed enough instruction in partnership tax law to at least understand the significance of the partnership agreements, including the agreement of September, 1967, on "draws", and how partners are taxed.

These same instructions would also have a direct effect on their deliberation of the question of intent, because it would give them an understanding by which to judge whether the Appellant did or did not act in the honest belief that the payments were non-taxable. --Without adequate instructions on taxability, they would have no "law" to go by except their own.

It must be emphasized here that the question of taxability was submitted by the Court to the jury as one of the three findings they had to make to find the Appellant guilty, with appropriately careful warnings not to consider the Government's schedule of Adjustments to Income (Exhibit 24) as evidence of taxability, but only as a summary that was no better than the evidence supporting it. (Tr. 244, 247, 248, 249, 252.)

Unfortunately, however, the Court did not explain the law relating to the evidence. The closest the Court came to talking about the law of the case was to say -- "If you find that the Defendant has not violated the law, you should not hesitate for any reason to render a verdict of not guilty." (Tr. 254, 255.)

III

REPLIES TO GOVERNMENT RESPONSES TO ARGUMENT III

(The Trial Court committed plain error by failing to include in the charge any mention of the law governing the degree to which a taxpayer has the right to rely on the written instructions of an expert accounting firm telling partners what they should pick up as taxable income from a partnership return prepared by the expert.)

A. Disclosure Confusion

The thrust of the Government's entire discussion under Point III seems to reflect a complete misconception and confusion regarding the prior requirement of full disclosure to an accountant in order for a taxpayer to later benefit from the legal defense of reliance on the advice of the expert.

What the Government is saying seems to amount to this -- Appellant had no legal right to rely on the written advice given to the partners regarding what they should pick up as taxable income from the U. S. Partnership Return. on the ground that the Appellant never disclosed information about his personal tax status to the accountants.

This is an incredibly wrong concept.

The disclosure requirement on the part of the Appellant, vis-a-vis the accounting firm, pertains only to full disclosure of partnership matters required for the preparation of a partnership tax return.

The Government may be confused by the fact that a partnership is an association of individual taxpayers, who are linked together on the U. S. Partnership Return as separate individuals, who must be given specific direction, as individuals, regarding where to go on the partnership tax form to pick up their individual taxable income.

A partnership is not a taxable entity for income tax, as is a corporation. Only the individual partners have taxable income from the partnership.

Consequently, an accounting firm that instructs individual partners is, by definition, giving personal advice to each partner -- to the extent that the firm establishes for each partner what his taxable income from the partnership is. --It is rather obvious that the expert can establish this without any prior knowledge of the taxpayer's other personal tax circumstances. The taxable income from the partnership is just one element that is transferred into the taxpayer's over-all personal income tax situation.

B. Absolute Need for Instruction

Appellant has already set forth in his main brief the factual basis in the evidence that inescapably establishes an absolute need for instruction on this point.

Since the Government has not presented a single point of law to justify the failure of the Court to even mention the letters of instruction received by Appellant with his U. S. Partnership Returns, we respectfully submit that Appellant is entitled to a reversal on this ground alone.

IV

REPLIES TO GOVERNMENT RESPONSES TO ARGUMENT IV

(The Trial Court erred in denying a judgment of acquittal at the close of the evidence on the ground that the evidence on either of the two elements of proof required in a tax evasion case -- taxability of the income, and intent -- was not sufficient to support a verdict.)

A. Evidence of Taxability of Income

It may seem astounding, but there is not a single reference, or discussion, in the Government's brief about any evidence produced at the trial to prove the taxability of the payments received by the Appellant.

Not a single Government witness was produced to testify as to the taxability of the income.

Not a single piece of evidence was introduced by the Government to prove the taxability of the income.

The argument that the payments were "guaranteed payments", (which we have shown is completely fallacious in our discussion under Argument I), has been put forth for the first time in this brief.

The only reference to evidence of taxability in the entire brief is a distortion of the testimony of "defense" witness Foody (who was subpoenaed by the Government), and Gravante, the Appellant's CPA expert. (G. Br. 3.) The distortion can be cleared up by reading the entire testimony of these witnesses.

In any event, there is no positive evidence whatsoever to prove the taxability of the income.

We have already stated in our main brief that it is Appellant that has established a prima facie case of non-taxability through:

(1) The McKinney and Fahey testimony regarding the September, 1967, agreement on "draws" for the three partners.

(2) The testimony of CPA Gravante regarding the effect of the agreement.

Accordingly, we submit to this Court that the insufficiency of evidence on taxability alone entitled the Appellant to a judgment of acquittal.

Not only was there not enough evidence to characterize the income as taxable beyond a reasonable doubt. there wasn't enough to even consider it.

B. Evidence of Intent

The same basic situation exists with respect to intent.

There is no hard evidence of intent. There are none of the usual indicia of fraud.

The Government tries to create an aura of concealment by repeating over and over again, in one form or another, that the Appellant did not report the income on his personal return.

The Government makes all kinds of statements, which on close examination have nothing to do with intent to defraud, and are entirely consistent with the actions of an innocent man.

There are also many serious misstatements of the record which we cannot take the time or space to enumerate here, but which are discoverable if the record is examined.

In any event, we submit that there was not, by any analysis, evidence of intent beyond a reasonable doubt.

Without such evidence, we respectfully submit, the Appellant was entitled to a judgment of acquittal at the close of the evidence.

CONCLUSION

There were prejudicial errors in the proceedings below. The trial was unfair and the evidence of guilt was insufficient as a matter of law. The judgment of conviction should be reversed, and judgment of acquittal granted.

Respectfully submitted,

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RE: UNITED STATES OF AMERICA v. THOMAS M. FAHEY

STATE OF NEW YORK)
COUNTY OF ONONDAGA) ss.:
CITY OF SYRACUSE)

EVERETT J. REA , being duly sworn, deposes and says:

That he is associated with Spaulding Law Printing Company of Syracuse, New York, and is over twenty-one years of age.

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JAMES M. SULLIVAN, JR.
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Everett J. Rea
Everett J. Rea

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Ruth A. Moloughney
Commissioner of Deeds

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